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Private Profits, Public Risks

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The fall in housing prices and mortgage values has exposed a serious flaw in the idea that private, shareholder-owned, government-sponsored enterprises (GSEs) can be effective instruments of government policy.

Two such GSEs, Fannie Mae and Freddie Mac, were chartered by Congress decades ago to create and operate a secondary market in residential mortgages. Initially government corporations, they were sold off to shareholders (Fannie was privatized in 1968, Freddie in 1986) in order to prevent their purchases and sales of mortgages from affecting the federal budget. This limited privatization created a unique hybrid enterprise: a shareholder-owned company that was supposed to act like a government agency.

Yesterday, the GSEs' regulator, the Office of Federal Housing Enterprise Oversight, agreed to reduce the small additional capital charge, over and above their statutory capital requirement of approximately 3%, that it imposed on the two companies four years ago. In doing so OFHEO said that this action will "support growth and further restore market liquidity." If this is true, the GSEs will be taking risks that no private, shareholder-owned company should take, given their limited capital and the fact that further declines in housing values could result in additional losses.

The two companies have already announced losses for the last two quarters, and projected additional losses in future quarters. Their capital positions -- about 4% of combined assets of about $1.7 trillion, with the current surcharge -- are considered "adequate" by their regulator. (A bank with 4% capital would be considered weak). Their share prices have fallen over the last year, and are now near their 52-week lows. Fannie Mae closed yesterday at 30.71, off its 52-week high of 70.57, and Freddie Mac closed at 19, off its high of 68.12. Under these circumstances, their shareholders could well wonder why the companies are now expected to take on more risk.

Confusion about the role of these two companies is rampant in Washington, and is particularly apparent in the views expressed by members of Congress. In a recent Senate hearing, Sen. Charles Schumer (D., N.Y.) expressed frustration with the way the two GSEs have reacted to the current housing problem. "Fannie and Freddie," he said, "have not lived up to my expectations when it comes to assisting borrowers who are having difficulty affording their loans."

This remark is of a piece with the senator's view that the special capital surcharge imposed by their government regulator should be relaxed so that they are able to buy more mortgages, even as mortgages are declining in value. His approach -- now apparently endorsed by the Bush administration -- seems to be based on the notion that Fannie and Freddie are still government corporations, expected to take losses in support of a national policy.

Contrast this position with the recent statement by Freddie Mac Chairman Richard Syron, who was asked a week ago whether -- in light of the company's losses -- he would be prepared to seek more capital. No, said Mr. Syron at that time, "this company will bow to no one on our responsibility to the shareholders . . . As long as we are what we are, it's clear what our fiduciary responsibility is."

His point is certainly valid. His responsibility, and that of his board of directors, is to act in the interests of the shareholders, and at that point he clearly believed that the shareholders of Freddie Mac would not be served by further dilution of their equity position. He must also believe that his shareholders would not be served by taking the risks that Sen. Schumer has in mind.

When the housing market was growing and housing prices rising, the contradiction between performing a government mission and serving the interests of private shareholders was obscured. Fannie Mae and Freddie Mac could report profits for their shareholders and still take on some of the risks that Sen. Schumer and others in Congress were demanding. The risks that were building up in the GSEs' balance sheets -- because of subprime loans, high loan-to-value mortgages, and affordable housing loans demanded by their congressional overseers -- were nowhere to be seen in their operating results.

The decline in housing values has exposed the scope of these risks. As Warren Buffett noted in his inimitable way, "When the tide goes out, you can tell who's been swimming naked." Now that housing values are falling, the losses inherent in the GSEs' risk-taking are coming to light. They are reacting as any shareholder-owned company would react -- by tightening credit, seeking as little additional capital as possible so as not to dilute the value of their owners' shares, and holding new risks at arm's length.

The GSEs can never be more than fair-weather friends to the government. Instead of countercyclical actors, they are decidedly procyclical, and may be largely responsible for the astounding and unsustainable growth in housing prices that is at the bottom of the current financial crisis. By creating GSEs to operate a secondary mortgage market, Congress created companies that would compound the very human problem of irrational exuberance -- when everything is going up they are gleeful buyers; when everything is going down, they sit tight and hope for the best. They will increase their capital only when it is absolutely necessary, and thus never develop the capacity to take the risks that their ardent supporters assumed they would take.

In other words, an expedient that Congress used many years ago to solve its budget problem -- while still supporting the housing market -- has proved worse than useless. The GSEs have only exacerbated the problem of an overheating market, and have neither the resources nor the appetite to assist in its resolution.

If Congress and the administration think that the government should be involved in countercyclical efforts to support the mortgage market, they should nationalize Fannie and Freddie. As real taxpayer-supported government agencies, they could then take the risks that an administration believes are necessary when the housing market begins to falter.

But this would be the wrong way to go. Given the GSEs' role in stimulating an overheated housing market, it would be better to privatize them entirely and get the government out of the business of subsidizing the market in mortgages. It's clear that private, shareholder-owned companies are incapable of responsibly performing the government mission now expected of them.

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